Client Alert

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New SEC No-Action Letter Lends Support to Unregistered Business Brokers

The Division of Trading and Markets (the "Division") of the US Securities & Exchange Commission (the "Commission") recently issued a significant no-action letter confirming that the Division would not recommend enforcement action under Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act") if an "M&A Broker" were to engage in certain described activities in connection with the purchase and sale of a "privately-held company" without registering as a broker-dealer under the Exchange Act.[1] The letter was written in response to a request from a group of individual lawyers. In reliance on this new no-action letter, so-called "business brokers" would be able to provide services and earn a commission in connection with a sale of a privately-held company without being required to register as a broker-dealer or to become a member of the Financial Industry Regulatory Authority ("FINRA").

Background

Because the US Supreme Court has held that sale of all the outstanding shares of a privately-held company involves the sale of a security,[2] there had been for many years a concern that business brokers should register as securities brokers and become members of FINRA. Many of these business brokers simply have chosen to ignore this requirement. If the broker assisted in the sale of the assets of the business instead of the stock of the company and no related securities were sold, these registration requirements would not be triggered. In case of both an asset sale or stock sale, the broker tends to perform similar services and earn similar fees, leading to the somewhat anomalous result that its activities could trigger extensive and costly regulation as a broker-dealer in one case and no such regulation in the other case. The SEC's no-action letter results in the stock sale being treated in a similar manner as an assets sale for broker-dealer regulatory purposes.

Key Definitions

In the letter, "M&A Broker" is defined as "a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company … through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company." The Division explains that the buyer could actively operate the company through the power to elect executive officers and approve the annual budget or by service as an executive or other executive manager, among other things.

For the purposes of the letter, the Division defines "privately-held company" as "a company that does not have any class of securities registered, or required to be registered, with the Commission under Section 12 of the Exchange Act, or with respect to which the company files, or is required to file, periodic

[1] *Faith Colish, Esq., Carter Ledyard & Milburn LLP, et al* (SEC No-Action Letter, January 31, 2014).

[2] *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

information, documents, or reports under Section 15(d) of the Exchange Act." The Division further specifies that the company must be an operating company that is a going concern and not a "shell" company, although temporary business combination "shell" companies are permitted to be involved.

Conditions for Application of No-Action Position

The Division relied on a number of representations in developing its no-action position, which are listed in the letter in detail. For this no-action position to apply, the following conditions, generally, must be true:

- The M&A Broker must not have the ability to bind a party to a merger, acquisition, business sale or business combination (each individually, an "M&A Transaction");
- The M&A Broker must not provide financing for the M&A Transaction;
- The M&A Broker must not have custody, control or possession of funds or securities issued or exchanged in connection with the M&A Transaction or other securities transaction for the account of others;
- The M&A Transaction must not involve a public offering;
- The M&A Broker must provide clear written disclosure and obtain written consent to the extent that it represents both buyers and sellers;
- The M&A Broker must not facilitate an M&A Transaction with a group of buyers unless the group is formed without the M&A Broker's assistance;
- The buyer, or group of buyers, in any M&A Transaction must control and actively operate the company or the business conducted with the assets of the company upon completion of the M&A Transaction. Control consists of the power, directly or indirectly, to direct the management or policies of the company, whether through ownership of securities, by contract or otherwise. Control would be presumed if the buyer or group of buyers has the right to vote 25 percent or more of a class of voting securities or the power to sell or direct the sale of 25 percent or more of a class of voting securities;
- The M&A Transaction must not result in the transfer of interests to a passive buyer or group of passive buyers;
- Any securities received by the buyer or M&A Broker in an M&A Transaction must be restricted securities within the meaning of Rule 144(a)(3) under the Securities Act of 1933; and
- The M&A Broker must have neither been barred nor suspended from association with a broker-dealer by the Commission, any state or any self-regulatory organization.

Some Reasons Supporting the SEC's Position

The letter requesting the no-action position summarized several reasons why typical M&A Transactions differ in most respects from traditional retail or institutional brokerage transactions. First, the buyer and seller are usually active in the transaction. A buyer usually conducts due diligence with the assistance of legal counsel, accountants and other business consultants. A seller often provides access to business-related information and is represented by legal counsel. Second, the services furnished to a buyer or seller by intermediaries vary widely and may include due diligence assistance, advice regarding potential buyers, valuation issues, structuring concerns and various business-related issues. Third, the terms and conditions of these transactions are usually negotiated between the buyer and seller and evidenced by written agreements involving lawyers, accountants and other business consultants. Fourth, as a result of

the existence of written agreements, there are typically remedies, both contractual and by operation of law, that are available to the parties of these types of transactions.

Conclusion

Although there are a number of conditions and requirements for this no-action position to apply, it is interesting that the no-action position is not specific to a particular fact situation, company or transaction. As a result, the generic nature of this letter appears intended to legitimize the widespread practice of business brokers who have chosen not to register as broker-dealers. It remains to be seen whether this no-action letter will create an uneven playing field from a regulatory and cost standpoint that results in some business brokers determining to deregister with the Commission to avoid the ongoing regulation and related costs.

Because this letter merely states the no-action position of the Division, it is important to note that it is not binding precedent on the Commission in any future legal proceedings or on the various state regulators with respect to the same issue.

For more information and background, we recommend that you read the Division's no-action letter and the underlying no-action request letter, which is provided by hyperlink at http://www.sec.gov/divisions/marketreg/mr-noaction.shtml#chron. Please also feel free to reach out to your Hunton & Williams LLP contacts to discuss any questions you may have.

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